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C O N F I D E N T I A L SECTION 01 OF 02 TBILISI 000169

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SUBJECT: GEORGIA: THE ECONOMY IS SAAKASHVILI'S TOP PRIORITY

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[1](#)B. B) 08 TBILISI 1912
[1](#)C. C) 08 TBILISI 2119
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Classified By: Ambassador John F. Tefft for reasons 1.4 (b) and (d).

[1](#)1. (C) Summary. Although in better financial shape than some of its neighbors, Georgia is starting to suffer from the overall international economic malaise. Georgia's banking sector remains sound due to high liquidity and conservative lending policies, but experts worry that a likely devaluation of the currency could trigger an increase in loan defaults. Pressure on the lari remains strong, because the country is dependent on dollar-denominated imports. Unemployment continues to rise, in large part due to the difficult state of the construction and real estate sectors. While unemployment officially stands at approximately 13 percent, actual unemployment is likely much higher. In the last three months, more than 3,000 people have been laid off in the banking sector alone due to a decrease in lending. While the initial shock to the Georgian economy came from the August conflict with Russia, the threats of the international economic crisis could be even more serious. The government understands the threat it faces from economic instability and has taken on an aggressive public strategy to address growing unemployment and economic uncertainty. An astute politician, President Saakashvili understands the population's uncertainty over the economy and is trying to address it. Saakashvili recently announced a 2 billion GEL economic stimulus package specifically geared at address unemployment concerns. End Summary.

CONTRACTION OF GDP

[1](#)2. (C) The impact of the world wide financial crisis is now being felt throughout the Georgian economy. While the initial shock to the economy came from the August war with Russia, the international economic crisis is bigger and more threatening to Georgia, both olitically and economically. Prior to the August conflict, Georgia experienced several years of double digit GDP growth. According to the Ministry of Finance, growth for the first half of 2008 stood at nine percent, and would have been higher had Georgia not instituted an aggressive campaign to combat inflation. However, due to the August conflict and the resulting drop in FDI followed by the global economic crisis, GDP declined in the second half of 2008, bringing overall 2008 GDP growth to an estimated two percent (Note: official GDP numbers are expected in March. End Note). Initial government and international financial institution predictions for 2009 have GDP growth pegged between two to four percent.

INFLATION DECREASES, BUT PRESSURE ON THE LARI INCREASES

[1](#)3. (C) Inflation for 2008 in Georgia came in at around seven percent according to early indicators from the National Bank. This is a significant achievement for the Saakashvili government, as year end 2007 inflation totaled 11 percent according to the state statistics agency (ref A). The

decrease in inflation was the result of a comprehensive strategy to tackle creeping consumer price increases. The government's anti-inflation strategy has continued into 2009, however, increasing pressure on the lari might require the government to back away from these plans. According to conventional economic theory, the current inflation control strategy would only work if the government allows the lari to float against the dollar. If the lari is allowed to float, the current pressure vis-a-vis the dollar would cause the lari to rapidly devalue. Without a floating exchange policy, the National Bank is continuing to spend reserves to meet the demand for dollars and keep the exchange rate at its current parity.

ADDITIONAL LARI DEVALUATION LIKELY

14. (C) In the months following the August conflict, the Georgian government was able to use reserves to maintain the lari-dollar ratio at around 1.45. However, the National Bank was rapidly burning through reserves (ref B) and began to worry about running out. A USD 750 million standby arrangement with the IMF helped the situation, as did the USD 250 million in budget support provided by the United States. Even with these dollar inflows, the government devalued (ref C) the currency on November 7 to 1.65 GEL per USD. Even while the government vowed to defend this parity, advisors to the National Bank, Ministry of Finance officials, and commercial bankers have suggested that the amount of the devaluation was not enough. They expect the currency to devalue further during the first quarter of 2009. If the government manages the devaluation, which is likely, the lari will probably move towards 1.85 per USD. However, if the

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government was to make the decision to let the lari float, even in a managed way, the rate could easily reach 2.00 GEL to USD.

SERIOUS IMPLICATIONS OF DEVALUATION

15. (C) In addition to possible inflationary pressures due to the increasing real price of imports, the Georgian banking sector would be hit hard by a devaluation of the lari. According to Ministry of Finance officials approximately 90 percent of Georgian consumer loans are denominated in dollars. This shifts the currency risk from the lender to the borrower. Many Georgians benefited in 2007 and the first half of 2008 from a weakening dollar, effectively decreasing the cost of their loans. The majority of these loans were made when the dollar-lari ratio was between 1.45-1.70. However, as the lari weakens the cost of servicing these loans increases. If the lari hit 1.95-2.00 per USD, many debtors could find themselves unable to pay back the banks. The heads of the two major Georgian commercial banks, TBC and Bank of Georgia, told EconOff that they are currently within their forecasted range for debt rescheduling, however, they are worried about managing a serious jump in defaults and debt rescheduling. Neither TBC nor the Bank of Georgia are currently lending to consumers beyond a small group of well-vetted clients.

UNEMPLOYMENT GROWING

16. (C) Unemployment has been steadily increasing over the last two months. The construction and real estate sectors are the hardest hit in the Georgian economy, with banking also experiencing significant challenges. Georgia's major export industries, namely ferrous metals and fertilizers have also been impacted by decreasing global demand and the resulting dip in prices, forcing layoffs. Many of the blue collar workers formerly employed on construction projects have found themselves out of work, as have a large number of those working in retail banking (ref D). The Georgian Government has vowed to keep unemployment under 14 percent; however, some government experts privately estimate

unemployment at already near 20 percent. A Ministry of Finance official told EconOff in a worse case estimate that as many as 250,000 individuals could be added to the unemployment rolls in the first quarter of 2008. According to the Georgian Statistics Agency, the labor force totals 1.9 million and official unemployment is 13 percent, making the actual number of unemployed approximately 250,000 people. This means that unemployment in the first part of 2009 could double. Add this to an increasing debt load for average Georgians, and the situation could be serious.

THE ECONOMY) THE GOVERNMENT'S ACHILLES HEEL

¶7. (C) President Saakashvili recognizes that the real domestic challenge for his government in the short term is economic. While repeated polling has shown the population has no appetite for new elections or street protests (ref E), economic hardship could quickly increase criticism of the Saakashvili regime. In response to this potential threat, Saakashvili is working hard to show his government is confronting economic challenges to help the Georgian people. He announced a two billion GEL economic stimulus package that envisions increasing social assistance, while strengthening infrastructure investments to create jobs. In a Georgian &New Deal of sorts, Saakashvili has pledged to undertake serious infrastructure investments, including road, railroad, building, and energy-related projects. According to a Ministry of Finance staffer, the infrastructure projects Saakashvili touted in his package are nearly all being done. Saakashvili touted in his package are nearly all being done through assistance pledges following the August war.

COMMENT: ONLY TIME WILL TELL . . .

¶8. (C) In the past, Saakashvili let his Prime Minister take the lead in economic affairs, but lately the President has been personally focused on economic issues. Georgia finds itself at a advantage compared to many of its neighbors because its economy is more developed and its banks more conservative and liquid. In addition, the assistance pledged following the August conflict gives Georgia a reserve of funds that others do not have at their disposal. If Georgia escapes 2008 with GDP growth between zero and two percent and can achieve the forecasted two to four percent growth in 2009, it will likely weather the storm. However, if the global economic crisis continues to worsen, decreasing the demand for Georgian exports and lowering FDI coming into Georgia, the economy could face a rocky road ahead.

TEFFT